United States Court of Appeals

for the Second Circuit

AMICUS BRIEF

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UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

No. 74-1573

H. PERINE,

Plaintiff-Appellant,

v.

WILLIAM NORTON & COMPANY, INC., et al.,

Defendants-Appellees.

On Appeal from the United States District Court
for the Southern District of New York

BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION, AMICUS CURIAE

STATEMENT OF THE CASE

The Facts

Plaintiff, a shareholder of Designcraft Jewel Industries, Inc. ("Designcraft"), brought this action in the District Court for the Southern District of New York on behalf of Designcraft against William Norton & Company, Inc. ("Norton") to recover, under Section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78p(b), profits allegedly realized by Norton through the purchase and sale in less

than six months of more than ten percent of Designcraft's common stock (3a-6a).[1] Norton had participated as co-underwriter, in a firm-commitment underwriting, for a public distribution of 300,000 shares of Designcraft stock (16a). Norton's participation in the underwriting amounted to 250,000 shares, which constituted 30 percent of the 817,500 total outstanding Designcraft shares (16a).[2] Plaintiff seeks recovery of the profits allegedly realized by Norton from its purchase and sale of the 250,000 shares in the underwriting.

Statute and Rule Involved

Section 16(b) of the Securities Exchange Act was enacted to curb "short-swing speculation by . . . insiders" of publicly traded corporations.[3] To effect that purpose Section 16(b) provides that a corporation which has an equity security registered pursuant to Section 12 of the Act, 15 U.S.C. 78l,[4] may recover the profits

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1/ "__a" refers to pages of the Joint Appendix.

Designcraft's stock was registered with the Commission pursuant to Section 12(g) of the Act, 15 U.S.C. 78l(g) (17a).

2/ One other underwriter, Seidlitz and Company, Inc., participated in the distribution to the extent of 50,000 shares (24a).

3/ Reliance Electric Co. v. Emerson Electric Co., 404 U.S. 418, 424 (1972).

4/ Securities registered pursuant to Section 12 consist of (1) securities traded on a national securities exchange which are registered with the exchange pursuant to subsection (b) of Section 12 and (2) over-the-counter securities which are registered with the Commission under subsection (g) of Section 12.

realized by an officer, director, or beneficial owner of more than ten percent of its shares, from a purchase and sale, or sale and purchase, of its stock within any period of less than six months. 5/ If the person purchasing and selling within the period of less than six months is a more-than-ten-percent beneficial owner, rather than an officer or director, then the statute further requires that in order to be

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5/ Section 16(b) provides:

> "For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months . . . shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months . . . . This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection."

The phrase "such beneficial owner, director, or officer" in Section 16(b) relates back to Section 16(a) of the Act, 15 U.S.C. 78p(a), which provides for the reporting of beneficial ownership of equity securities and changes in such ownership by "[e]very person who is directly or indirectly the beneficial owner of more than 10 per cent of any class of any equity security (other than an exempted security) which is registered pursuant to Section 12 of this title, or who is a director or an officer of the issuer of such security . . . ."

subject to Section 16(b) liability, he must have held more than ten percent "both at the time of the purchase and sale." In construing that phrase in Stella v. Graham-Paige Motors Corp., 232 F. 2d 299, 301 (C.A. 2, 1955), certiorari denied, 352 U.S. 831 (1956), sustaining 104 F. Supp. 957 (S.D. N.Y., 1952), this Court held that a person who purchases beneficial ownership of more than ten percent of the corporation's shares is deemed to be a beneficial owner at the time of such purchase and accordingly that that purchase may be matched with a sale occurring within less than six months for purposes of finding Section 16(b) liability. 6/

Section 16(b) further provides that the Commission, by rules and regulations, may exempt transactions "as not comprehended within the purpose" of that section. Pursuant to this authority the Commission has adopted Rule 16b-2, 17 CFR 240.16b-2, which exempts transactions of purchase and sale, or sale and purchase, in connection with a distribution of a substantial block of securities where the transaction and the person effecting it satisfy certain conditions

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6/ Accord, Emerson Elec. Co. v. Reliance Electric Co., 434 F.2d 118 (C.A. 8, 1970), aff'd on other grounds, 404 U.S. 418 (1972); contra, Provident Securities Co. v. Foremost-McKesson, Inc., [Current Binder] CCH Fed. Sec. L. Rep. ¶94,811 (C.A. 9, 1974).

specified in the rule.[7/] The condition which is the subject of this appeal appears in clause (a)(3) of the rule, which provides that,

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7/ Rule 16b-2 provides:

"Exemption from Section 16(b) of Certain Transactions Effected in Connection with a Distribution

"(a) Any transaction of purchase and sale, or sale and purchase, of a security effected in connection with the distribution of a substantial block of securities shall be exempt from the provisions of Section 16(b) of the Act, to the extent specified in this rule, as not comprehended within the purpose of said section, upon the following conditions:

"(1) The person effecting the transaction is engaged in the business of distributing securities and is participating in good faith, in the ordinary course of such business, in the distribution of such block of securities;

"(2) The security involved in the transaction is (A) a part of such block of securities and is acquired by the person effecting the transaction, with a view to the distribution thereof, from the issuer or other person on whose behalf such securities are being distributed or from a person who is participating in good faith in the distribution of such block of securities, or (B) a security purchased in good faith by or for the account of the person effecting the transaction for the purpose of stabilizing the market price of securities of the class being distributed or to cover an over-allotment or other short position created in connection with such distribution; and

(continued)

in order for a transaction to be exempt under the rule,

> "[o]ther persons not within the purview of Section 16(b) of the Act. . . [shall be] participating in the distribution of such block of securities on terms at least as favorable as those on which. . . [the person effecting the transaction] is participating and to an extent at least equal to the aggregate participation of all persons exempted from the provisions of Section 16(b) of the Act by this rule."

The Decision of the District Court

The plaintiff and Norton both moved for summary judgment. Plaintiff argued that Norton was liable under Section 16(b) for its

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7/ (footnote continued)

> "(3) Other persons not within the purview of Section 16(b) of the Act are participating in the distribution of such block of securities on terms at least as favorable as those on which such person is participating and to an extent at least equal to the aggregate participation of all persons exempted from the provisions of Section 16(b) of the Act by this rule. However, the performance of the functions of manager of a distributing group and the receipt of a bona fide payment for performing such functions shall not preclude an exemption which would otherwise be available under this rule.
>
> "(b) The exemption of a transaction pursuant to this rule with respect to the participation therein of one party thereto shall not render such transaction exempt with respect to participation of any other party therein unless such other party also meets the conditions of this rule."

profits in connection with the underwriting since Norton purchased and sold more than ten percent of Designcraft's total outstanding shares, pursuant to the underwriting, in less than six months. This transaction, plantiff asserted (17a), was not eligible for the exemption from Section 16(b) liability granted to underwriting transactions by Rule 16b-2, since Norton's distribution of 250,000 shares out of the total distribution of 300,000 shares prevented compliance with the condition in clause (a)(3) of the rule that other persons who are not subject to Section 16(b) must participate in the distribution to an extent at least equal to the participation of all persons exempted from Section 16(b) by the rule.

Rejecting plaintiff's position, the district court (Ward, J.) granted summary judgment in favor of Norton, dismissing the action on the ground that Norton was not within the class of persons required to meet the conditions established in clause (a)(3) of Rule 16b-2 in order to receive an exemption from Section 16(b) under that rule. 372 F. Supp. 341. Judge Ward acknowledged that, consistent with the holding in Stella, supra, the transaction by which an underwriter in a firm-commitment underwriting acquires more than ten percent of the issuer's outstanding shares is matchable with a subsequent sale of those securities for purposes of computing Section 16(b) liability. 372 F. Supp. at 344. He reasoned from the history of Rule 16b-2, however, that the condition imposed by clause (a)(3) of the rule should not be read to apply to underwriters whose insider status under Section 16(b) arises from their becoming beneficial owners

of more than ten percent of the issuer's shares at the time of, and as part of, the underwriting itself. Rather, clause (a)(3) should be read to apply only to those persons who had an insider relationship with the issuer prior to the underwriting. Accordingly, since Norton had no pre-existing insider relationship with Designcraft at the time it purchased more than ten percent of Designcraft's outstanding stock as part of the underwriting, it was not required to meet the conditions of clause (a)(3).

POSITION OF THE SECURITIES AND EXCHANGE COMMISSION

The Commission is of the view that the district court correctly decided that an underwriter who acquires beneficial ownership of more than ten percent of an issuer's outstanding shares in the course of an underwriting, but who is not otherwise an insider of the issuer for purposes of Section 16(b) of the Act, need not satisfy the conditions of clause (a)(3) of Rule 16b-2 in order to receive an exemption from Section 16(b) under that rule. 8/

8/ The Commission's brief is limited solely to the issue of whether Norton had to meet the conditions of clause (a)(3) of Rule 16b-2 in order to be exempted from Section 16(b) liability. Clause (a)(1) of the rule imposes an additional condition that the person effecting a transaction for which he is seeking an exemption from Section 16(b) liability under the rule must be participating in the underwriting "in good faith." The parties have not raised the applicability of this condition. We note in this regard, however, that on April 2, 1974, subsequent to the decision below by Judge Ward, the Commission instituted an administrative proceeding, In the Matter of William Norton & Company, Inc., et al., Administrative Proceeding File No. 3-4466, in which it was alleged, among other things, that Norton manipulated the price of Designcraft stock by using customers' accounts to depress the price of Designcraft stock at the time of the

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To avoid future uncertainty as to the meaning of clause (a)(3), the Commission's staff is considering an appropriate clarifying amendment to Rule 16b-2 to make clear that clause (a)(3) does not apply to an underwriter who becomes a Section 16(b) insider solely because he acquires beneficial ownership of more than ten percent of the issuer's shares in the course of participating in the underwriting.

8/ (Footnote continued)

underwriting, and then to inflate the price of the stock in the aftermarket while at the same time disposing in the aftermarket of stock which Norton had taken through the underwriting but intentionally withheld from distribution. This administrative proceeding against Norton is based, in effect, on allegations that Norton was not participating in the Designcraft underwriting in good faith, but rather was using the underwriting as a vehicle for manipulating Designcraft stock. The fact that the Commission in this amicus curiae brief is supporting Norton's argument that as a matter of law Norton was not required to comply with the provisions of clause (a)(3), in no way reflects any conclusion by the Commission as to the merits of its administrative proceeding.

ARGUMENT

From 1935, when Rule 16b-2 (then Rule NB2) was adopted by the Commission, until 1952, an underwriter like Norton, whose insider status under Section 16(b) arose from a more-than-ten-percent beneficial owner relationship, rather than from a director or officer relationship, would not have been required to satisfy the conditions which now appear in clause (a)(3) of Rule 16b-2 in order to obtain an exemption from Section 16(b) under the rule. Until 1952 those conditions were expressly made applicable only to underwriters whose insider status resulted from an officer or director relationship -- i.e., only if the underwriter was an officer or director of the issuer, or if the underwriter was a partnership or corporation affiliated or connected with an officer of director of the issuer. This distinction between an officer or director relationship, on the one hand, and a more-than-ten-percent beneficial owner relationship, on the other hand, appeared in the original 1935 version of clause (a)(3) [9/] and was retained in all amendments adopted prior to 1952. [10/] Thus, the 1947 version, which remained in effect until 1952, provided in pertinent part:

9/ Securities Exchange Act Release No. 264 (Class B) (June 28, 1935).

10/ Securities Exchange Act Release No. 535 (Class B) (March 19, 1936); Securities Exchange Act Release No. 1080 (February 27, 1937); Securities Exchange Act Release No. 3907 (January 29, 1947).

> "If the person effecting such transaction is either (1) an officer or director of the issuer, (2) a firm of which an officer or director of the issuer is a partner, employee, appointee, nominee or representative, or (3) a corporation or other person in respect of which an officer or director of the issuer is an officer, director, employee, appointee, nominee, representative or beneficial owner, directly or indirectly, of more than 10 per centum of any class of equity security, then one or more other persons who are not specified in clause (1), (2) or (3) of this paragraph shall have participated in the distribution as members of the underwriting group on terms at least as favorable as those on which such specified persons have participated and to an extent at least equal to the aggregate participation of all such specified persons . . . ." Securities Exchange Act Release No. 3907 (January 29, 1947) (emphasis added).

In 1952, in the course of adopting an amendment to Rule 16b-2 which is not material to the present discussion (an amendment to clause (a)(2)), the Commission also substantially redrafted clause (a)(3). In so doing, the Commission changed the "if . . . then" formulation of clause (a)(3) that had distinguished between different categories of insider relationships, to the present blanket requirement which draws no such distinction.[11/] However, neither the Commission release announcing that the proposed 1952 amendments were under consideration[12/] nor the subsequent release announcing adoption

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11/ Securities Exchange Act Release No. 4754 (September 24, 1952).

12/ Securities Exchange Act Release No. 4719 (June 18, 1952).

of the amendments[13/] contains any explanation of the changes made in clause (a)(3). In light of this circumstance, we believe that the 1952 amendment to clause (a)(3) was not intended to have the substantive effect of changing the scope of that clause. Rather, it apparently was intended to simplify the rather cumbersome language of the previous formulation of clause (a)(3). For if the Commission had intended to affect the meaning of clause (a)(3), that intention would presumably have been reflected in the accompanying releases.

That the 1952 amendment to clause (a)(3) was not intended to work a change which would make the requirements of that clause applicable to an underwriter like Norton is further demonstrated by an examination of the clause's underlying purpose. As the Commission has explained, the conditions prescribed by clause (a)(3) were intended to prevent insiders from "acquiring a preferential position where they participate in a distribution."[14/] Underwriters like Norton, who become insiders for Section 16(b) purposes solely by acquiring more than ten percent of the issuer's shares during

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13/ Securities Exchange Act Release No. 4754 (September 24, 1952).

14/ Securities Exchange Act Release No. 3907 (January 29, 1947).

the course of the underwriting, are not in a position to use their insider position to acquire a preferential position in the underwriting. Rather, any preferential position that such an underwriter may obtain is the result of negotiations which antedate his insider status.

CONCLUSION

For the foregoing reasons the Commission believes that the district court correctly decided that an underwriter who acquires beneficial ownership of more than ten percent of an issuer's outstanding shares in the course of an underwriting, but who is not otherwise an insider of the issuer for purposes of Section 16(b) of the Act, need not satisfy the conditions of clause (a)(3) of Rule 16b-2 in order to receive an exemption from Section 16(b) under that rule.

Respectfully submitted,

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October 1974

SECURITIES AND EXCHANGE COMMISSION
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OFFICE OF THE
GENERAL COUNSEL

October 31, 1974

A. Daniel Fusaro, Esquire
Clerk, United States Court of Appeals
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Re: Perine v. William Norton & Company, No. 74-1573

Dear Mr. Fusaro:

Enclosed for filing are twenty-five copies of the Brief of the Securities and Exchange Commission, Amicus Curiae. We regret that we were not able to file this brief on October 29, 1974, as originally intended.

I hereby certify that I have caused two copies of this brief to be served by United States mail, postage prepaid, upon each of the following persons:

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Sincerely,

Theodore L. Freedman

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Enclosures

cc: Stanley C. Kaufman
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